The Role of Securities Commissions

by

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RECOMMENDATIONS OF WORKING GROUP II: ROLE OF SECURITIES COMMISSIONS

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This report deals with the recommendations and conclusions from Workshop II of IOSCO's Development Committee, held in Mexico in May 1990. More precisely, it deals with the key points raised in the discussion that followed the submission of the paper on Functions and Role of Securities Commissions. An effort has been made to relate these points to one another in a general framework that may guide further discussion on the matter. The idea is to come up with a blueprint of a Securities Law that might help establishing new capital markets or amend existing laws.

This report is organized around the following recommendations of the working group:

I. Who sets the prices of issues and securities: the importance and scope of a market frame.

II. The Securities Commission as a specific supervisor:

II.1. Regulation by function, not by institution.

II.2. Main areas of supervision: where and how to regulate.

III. Commission's autonomy: legal, political and financial aspects.

IV. Concluding remarks: how much to regulate.

I. WHO SETS THE PRICES OF ISSUES AND SECURITIES: THE IMPORTANCE AND SCOPE OF A MARKET FRAME.

By their very nature, Securities Commissions act within a market economy; this is the environment they must operate in. This means that the investment resources must be allocated by the market, and that this is the mechanism that sets the prices of securities.

Concerning price setting as such, Securities Commissions have no role to play. These Commissions being supervisory entities, they do not set, determine or approve securities prices, but they oversee the operations carried out in the market place. It is in this capacity, however, that they have a say in price setting, but before going into that a little philosophy is called for.

According to microeconomic theory, the best resource allocation and its most efficient use stems from a market mechanism, based on which society maximizes production given a limited resources allowance. If so, why do market operations have to be overseen? The answer, particularly applied to financial industry, is that they are overseen and regulated in order to protect the investing public from malpractices; to spread risk-bearing among the participants; to instil confidence and to promote stability in the system, all of which is necessary to encourage savings and the efficient allocation of resources.

But then, why must investors be protected and confidence enhanced? Among the basic assumptions of a perfectly competitive market, mention must be made of perfect information and of lack of monopolistic power. If the assumption of perfect information is dropped and risk and/or uncertainty are allowed for, perfect competition does not provide for an efficient dynamic solution. In ordinary words, this could mean that the economy by itself does not necessarily reach equilibrium continuously and smoothly in everyone's interest; or that it balances automatically but not instantaneously. It is on these grounds that economic policies are required.

Monopoly power, in turn, reflects the power of imposing prices. In perfect competition no participant, whether seller or buyer, issuer or investor, is significant enough in relation to market size as to affect goods and services prices. But large economies of scale, barriers to entry or exclusivity in the property of resources are in the origin of such a power. The outcome is a distorted allocation of resources, that typically results in a higher price and a poorer provision of the monopolized good or service than in the social optimum.

In the securities industry neither economies of scale nor natural barriers to entry seem to explain by themselves a monopolistic situation -this is most usually due to the monopolistic possession of a scarce resource, such as information, or exclu-

sive access rights to this or some other sophisticated service. Actually, dealers associations and exchanges have been known to exert their organizational power to limit entrance of new members or favor the setting of their services' fees.

Problems related to information and monopoly power are not the only ones that must be dealt with in a market economy. There are, too, some considerations of social justice that might merit government's intervention -it must be borne in mind that some ideas of fair procedures or equal opportunities are not always a part of the market system. Those are rather vague concepts indeed, but they lie in the very basis of the social consensus and have an essencial role to play in framing the relationship among the government, the market, and society at large.

The most feasible solution to cope with all this is the government' direct intervention in order to ensure competition. It is in this context then, that the Authority's intervention must be understood. Otherwise said, the Commission should prevent monopolistic power from been exerted: prohibition of non desirable mergers or acquisitions, antitrust laws, punishment to oligopolistic price determination, mandatory disclosure rules on the part of issuers and the legal prosecution of inside information, are examples of protection of competition.

Yet regulation is no substitute for competition. Just as competition alone fails to protect investors and provide a fair securities industry, so does the regulatory body, which is not an omniscient, neutral umpire. The trouble is, as in many other things, to achieve the right balance bewtween one and the other. Reliance on disclosure requirements, therefore, should prevail over standard setting and prohibitions.

II. THE SECURITIES COMMISSION AS A SPECIFIC SUPERVISOR:

II.1. REGULATION BY FUNCTION, NOT BY INSTITUTION.

Securities Commissions must be technical, specific entities specializing in their own scope, that is, the securities market. In other words, Commissions are to be independent, autonomous organizations, either from the Central Bank or the Ministry of Finance.

The principle can not be overemphasized that **regulation must be made by function, and not by institution.** This implies that entities operating in the securities industry must be overseen by a Securities Commission or Authority, and not, let's say, by the Central Bank, whose mission and powers are related to monetary topics instead. The Ministry of Finance should be excluded as well, due to the political independence that regulation must exhibit. Likewise, entities operating in money and credit markets must be overseen by an ad hoc, appropriate Authority, spe-

cially devoted to these matters. This recommendation aims at precluding conflicts of interest -among owners and customers of a financial institutions; among these in their different roles; between regulated and regulatory entities, and among each of the latter.

Regulation by function is all the more important in view of the current trend toward despecialization and diversification of formerly distinct financial services and products. This blurs not only the identities of the financial institutions offering them -such as investment versus commercial banks, or these versus securities dealers- but it also blurs, which can be serious, the regulatory and comptrolling responsibilities of the different supervising entities. Regulation by function, then, prevents overregulation, strengthens the specialization and know-how of supervising authorities, and enhances the economies of scale involved in their overseeing just similar kinds of financial activities.

Warning must be given that defining intermediary functions or identities for regulatory purposes is by no means easy. That notwithstanding, were regulation not made by function but by institution many social benefits of a competitive capital market would be lost. Of these, perhaps the most important one is transparency, that is, the availability of timely, reliable corporate information, for when the economy is strongly bank-orien-

ted access to financial information tends to be restricted to banks only, and the information released to the general public most certainly is not a top quality one.

Another such loss would be the drive toward innovation and competition in the capital market, where some financial activities will be crowded out into the informal, non regulated sector. Needless to say, this will resolve in the all too well known viciuos circle of a shallow securities market: heavy reliance on bank financing lowers the possibilities for corporations to raise funds through the capital market. The thinness of the latter makes manipulation easier, which discourages the public from investing there; consequently, prices fall and costs rise, preventing companies from placing their instruments through the capital market.

One further reason for recommending that regulation be made by function rather than by institution is that both types of supervision adopt different views and impose different margins and requirements, because both the banking and the non banking financial sector are subject to quite different types of risk.

In this context, comparison between banks and securities firms must be made in their common capacity as intermediaries - and not, as the case might be, as issuers or investors, for banks can be anyone of them just as brokerage firms can be investors.

Banks can play an important role as intermediaries in the capital market, be it as broker-dealers, underwriters, portfolio managers and/or depository systems. Differences still remain, however, between the approaches needed for brokerage firms and those applied to banks.

Securities institutions can operate for a third party -intermediation- and for their own account. In these short term position takings they must stand ready to face position and settlement risks, among others. Accordingly, securities firms are required to hold an adequate enough capital to deal with those particular risks. This includes marking their assets to market on a continuous basis so as to reflect actual value; and holding a cushion capital against actual or potential losses arising from unexpected price swings. This is why securities authorities impose stringent liquidity requirements over intermediaries.

As for banks, the basic risk they encounter is credit risk, for they are supposed to keep their assets to maturity. With the aim of ensuring that they be able to meet claims as these fall due, banking supervisors monitor the long-term maturity mismatch of banks'portfolios. In so doing they neither require those assets to be marked to market, nor do they emphasize liquidity for a large part of their positions. The margin required for banks'securities operations is a constitutive portion of the global capital banks must hold for all their businesses. Though

this capital makes banks less vulnerable to market fluctuations than securities firms are, it can not vary along with securities tradings, as dealers' margins certainly do.

These structural features of the supervised entities allow, then, their supervisors to impose the different approaches and requirements referred to above. Unlike banks regulators, securities regulators tend to take or can take a more flexible and short-term view of their task; consequently, there might be a loss of efficiency in one of them imposing its views upon the realm of the other, or in just one of them (or a third authority, such as the Central Bank) overseeing both banking and securities institutions.

II.2. MAIN AREAS OF SUPERVISION: WHERE AND HOW TO REGULATE.

According to the principal functions entrusted to it, the Securities Commission or Authority may be organized in departments or divisions covering specific segments of the market, that is, divisions overseeing entities with similar objectives or accounting and administrative procedures. Thus, for instance, the following areas of regulation would come up:

a) Issuers of publicly offered securities, specially public corporations: here one must separate the open and the closed ones, on the ground that operations by the latter do not entail public

trust and thus require no regulation. This calls for a more detailed supervision of the former in the trading of its securities.

All instruments for public subscription should be registered with the Securities Commission in order to make sure that reliable, timely and accurate information concerning the issues and the issuers is disclosed to guide prospective investores in making informed judgement. It is important for the overseeing body to set minimun information requirements that must be met by every registrant. The supervisory board should nevertheless be entitled to call for additional information when necessary.

b) Securities **intermediaries:** here stock exchanges and their operations are included, as well as brokers, dealers and investment banks. Their activities must be monitored and supervised to keep proper standards of conduct and professionalism and to ensure orderly and equitable dealings in securities.

c) **Institutional investors,** such as mutual funds and their managing companies, all kinds of investment funds and, may be, pension funds and their managing corporations, as well as insurance and investment companies. They must be regulated not least because of their potentially strong influence over the economy. In terms of point I above, institutional investors could get to be significant enough in relation to market size as to affect securities prices.

d) Other entities whose operations entail public trust and confidence, such as rating agencies or Clearing and Settlement Houses. Here, supervision tends to ensure professional, impartial operations.

These areas or others that could arise should, certainly, be accompanied by a general area that might be called Legal Advisory or Enforcement Division, as well as one or several specialized areas of financial analysis, auditing and inspection, and still another for research and development. In addition to these, the Securities Commission must include all other areas suitable to this type of organizations, such as Computer Department, General Secretariat, Budget and Personnel.

Before leaving this point, a word must be uttered concerning how to regulate. When we use the word regulation here, we mean real enforcement, for otherwise plain regulation becomes dead letter. And real enforcement means thorough analysis of financial statements and information disclosure, control and prosecution of fraud and of inside information, monitoring auditing and auditors independence standards, registration provisions and so forth.

Were individuals or entities overseen by the regulating body fail to abide by the laws, rules, releases and other ordinances governing them, or the Authority's directives, the latter may

sanction them with censorship, fine or revocation of authorization. Of course, those affected must be granted the right to appeal.

III. COMMISSION'S AUTONOMY: LEGAL, POLITICAL AND FINANCIAL ASPECTS.

The legal, financial and political autonomy of a Securities Commission is a necessary condition for the thorough and efficient fulfillment of its duties. Its delicate mission of supervising this sensitive and often fragile a market is to be subject to no political or financial pressures, nor to restrictions of any source.

Financial autonomy: the independence of the regulatory body, specially in financial matters, should be safeguarded by its own revenues granted by its Enablig Law which, incidentally, guarantees the Commission's legal autonomy. The Authority should also be entitled to the resources transferred to it by the Public Treasury or the Nation's Budget or as an annual subvention from the Central Bank, or something of the sort. Of course, these or any such similar arrangements are specific of every legal and institutional framework.

The ideal course of action would be to completely sever the Commission's financial ties with the Public Treasury, but this is

deemed to be very difficult in emerging countries, particularly when setting up the Commission. Besides, in most economies revenues from the Public Treasury or the Central Bank are scarce and contingent. The need arises, then, for the supervisory board to raise funds by charging regulated entities for services to be rendered, or levying them as a proportion of issuance value of public offered securities, or as a proportion of net wealth or some other concept. There are Commissions that autonomously administrate the said revenues, while some others wholly or in part turn them to the Treasury.

If possible, these charges must be set from the very beggining -when establishing the Commission- and not later when the authority is already in office, because of the obvious difficulties this would entail. And even where the Commission can be self sufficient regarding the funding of its activities, in emerging economies this must be cautiously done so not to put an undue burden upon them, particularly so upon small entrepreneurial ventures and firms.

Legal and administrative autonomy: autonomy is not guaranteed by financial resources only, nor should financial independence be the sole consideration, for legal and political autonomy must also exist. These are necessary conditions for the proper performance of the regulatory entity, so that these activities may develop within a technical framework free from political pressures of any kind.

As it is so important that the Commission be seen by all and sundry as a technical organization, a mechanism must be set forth to generate the authorities and to define the restrictions imposed upon them. For instance, the top executive of the Commission (or all the members of a board, as the case might be) could be appointed by the Head of the State with Parliament's approval, which would also be required in the event of their dismissal, if and when it is proved that they incurred in offenses previously outlined in a legal body.

All this must be coupled with legal recourses making appeals possible before the Courts, where performance and decisions of the Commission will be aired. Otherwise said, in order to prevent excesses the regulatory board should be able to sue or be sued by any agrieved party, and the decisions of the court must be final, superseding the judgements of the regulatory authority. Perhaps the latter should make periodic reports to the supervisory ministry (or to a government's comptroller organism) which should have the powers to question any activity of the regulatory board that is not in consonance with its Enabling Act and regulations.

IV. CONCLUDING REMARKS:

Given that competition and regulation are no substitute for one another, Commissions have to rely on both of them to encoura-

ge fair and orderly markets that promote broad-based investor participation and confidence.

This general statement can take number of different aspects, particularly so in emerging markets. The first one is that in these, Securities Commissions can not or should not be just regulatory entities, for in addition they must encourage market's development and growth. Actually, in developed economies securities commissions can have solely a regulatory role, since these markets are already well developed. In emerging markets, however, these commissions may be burdened with both regulatory and developmental functions, given these markets' level of development.

A further aspect of the statement is that regulation is not an end in itself, given that Commissions are primarily concerned with investors' interest and confidence. **Regarding market development, then, regulation is a necessary but not a sufficient** condition: those markets that have developed the more and the better are not the heavily regulated ones, but those that have successfully attained the right balance between regulation and competition.

Of course, in this task the authorities must be fully aware of the trade-off involved in their double role: on the *one hand* they have to protect and stimulate competition; on the other,

they need to prevent fraud and instability, since markets will hardly thrive which do not provide for investors'protection.

Let it not be forgotten, anyway, that the authority is not a neutral umpire whose intervention imposes no cost upon the economy. As regulation is a necessary complement of competition, its cost must be no higher than that of the imperfections being corrected or prevented, lest it should overburden market-based mechanisms. Thus impartial, prudential, clear rules foster rather than encumber competition.

Rules can not be restrictive or binding in so dynamic an activity. On the contrary, Commissions must be aware of changes, new developments, needs and technologies, so to keep adapting the legal frame in force. This frame must be as flexible and dynamic as is the market, and as supervision must be should it make an effective contribution to development. The supervising authority must define the objectives of its regulation, choose between quality versus quantity of it and decide which burdens to ease and which to enforce, if any.

Finally, there is a very important tool to which this report has devoted not one word yet -self regulation. Self regulation is the right or privilege an association -be it of dealers, stock brokers, management companies- is entitled to, whereby legislative powers and disciplinary action are vested in its membership.

After all, the supervisory board is not the sole responsible for the securities industry's good performance, nor should it be so. Those to whom the benefits directly accrue to, must have a say in their own affairs. Consequently, **any attempt of supervision must combine information disclosure, regulation and self regulation** in the proportion that particular circumstances and cases might call for.